

**International Studies Program
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Tax System Change and the Impact of Tax Research

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Abstract

This paper considers the proposition that recent tax policy trends have been decisively influenced by tax research. In both the OECD countries and developing countries, the two most important changes in tax systems in recent decades have been the introduction of the VAT and the general lowering and flattening of statutory income tax rates. The downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by the increasing research measuring the distortions caused by high marginal tax rates. Equally, the widespread adoption of VAT is probably due at least in part to acceptance of the economic argument that this form of sales tax is less economically distorting. For the most part, however, countries have not done these things because economists produced persuasive theories or empirical evidence that it would be good to do them but for their own reasons. After reviewing a number of aspects of how tax policy decisions are made in practice, the paper concludes that if tax scholars are interested in improving policy, they should focus not on the short-term political game within which policy decisions are inevitably made in all countries but rather on the long-term game of building up institutional capacity, both within and outside governments, to articulate relevant ideas for change, to collect and analyze relevant data, and to assess and criticize the effects of such changes as are made. Economic research may provide valuable inputs into policy decisions, both because it is the only approach focusing on efficiency concerns and because it can (but often fails to) say some useful things about the distributional outcomes that impact more immediately on policy decisions in most countries. But it is not and cannot be a substitute for the development of the political institutions that need to exist if 'good' tax policy is to be developed and implemented.

Keywords: tax policy; tax research; developing countries; administration; political economy.

JEL: O23, H20, B25

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Introduction

The three decades between the end of World War II and the first oil crisis of the mid-1970s have sometimes been called *les trentes glorieuses*, the thirty glorious years – years that, at least when viewed with the rosy nostalgia of hindsight, produced growth and increasing prosperity for all. In reality the 1945-75 period was more nuanced and differentiated than this label suggests, and it was doubtless far from “glorious” for many, not least in the very heterogeneous group of “non-OECD” (or “developing”) countries. It is no surprise that the subsequent three decades that are the focus of this paper have also produced mixed results, not least in the fiscal sphere.

Of course what one sees always depends not only on where one sits but also on precisely where (and when) one looks – as well as on what one is looking for. What I am looking for in this paper is essentially evidence that recent tax policy has been influenced by tax research. Or, to put it another way, what evidence is there that tax researchers have been focusing on the problems that really shape tax policy?

Most tax research is carried out in the OECD countries that are the principal focus of this volume, and the issues discussed here are of course relevant to those countries. For the most part, however, I focus in this paper on developing (non-OECD) countries. I do so for three reasons. First, since in the era of globalization we are all in a real sense in the same boat, it may be useful even for those whose primary concerns are for a particular developed country to reflect in more general terms on how tax issues arise and are dealt with around the world. Second, since both the fiscal problems and the concerns about the relevance of much economic research on taxation are greater in developing countries, the question raised above comes out most sharply in this context.² Finally, the dominance of “first-world” economists both in shaping tax research and in giving advice on tax policy to developing countries, suggests that experience in the non-OECD world may provide a particularly clear test of whether that advice makes sense. Have we been giving good advice? Has anyone been listening? Are there important issues to which we should pay more attention if we want tax research to contribute more to tax system improvement? How may tax researchers in any country, OECD or developing, be more successful than experience suggests they have been to date not only in “speaking truth to power” (Wildavsky 1979) – but also in being heard?

Trends in Taxation

How countries tax themselves changes continuously, as Heady (2009) has recently discussed in detail with respect to OECD countries and as Norregaard and Khan (2007) review in broader perspective. The world changes, and so taxes. New research may also change our understanding and ideas about what constitutes a good tax system.

² Some portions of the present paper draw heavily on an earlier treatment of some of these issues in Bird (2007).

At first glance, it may thus be surprising to learn that neither tax levels nor (in broad perspective) tax structures in developing countries look all that different than they did 30 years ago. This outcome seems especially odd since most developing countries face substantial fiscal challenges both from their changing environments and often from the international development community, which constantly delivers often conflicting messages to spend more, spend better, tax more, and tax better. A recent IMF (2005) assessment, for example, set out a revenue-to-GDP ratio of 15-20 percent as a reasonable minimum “threshold” for developing countries.³ Similarly, the UN Millennium Project (2005) informed developing countries that on average they need to mobilize an additional 4 percent of GDP in tax revenue to achieve the minimal targets set by the project (the Millennium Development Goals) -- that is, to increase from their current average tax level of 17-18 percent to something closer to 22 percent.

Tax Levels

As Table 1 shows, on average the share of taxes (excluding social security) increased from 30 to about 35 percent in recent decades in the developed (OECD) countries.⁴ In developing countries, however, the tax share of output increased only slightly: indeed, since the 1980s their tax shares have been almost constant.⁵ In contrast, an earlier study found that the average tax ratio for central governments in (a smaller sample of) developing countries had increased by about 24 percent over the previous two decades, suggesting that “convergence” in tax levels between developed and developing countries appeared to be well on its way (Chelliah 1971). The last few decades have changed the picture. In fact, at the beginning of the present century, the tax ratio in developed countries was roughly twice that in developing countries -- a much greater difference than in the 1970s.⁶

³ ‘Revenue’ (even current revenue) and taxes are not identical, although IMF (2005) seems to use the two words interchangeably. However, Bird, Martinez-Vazquez and Torgler (2006) analyzed both revenue and tax ratios in developing countries and found no great differences in most instances.

⁴ The two brief tables included in this section as well as some of the discussion follow Bahl and Bird (2008).

⁵ In the transitional countries (the former Soviet bloc countries as well as China and Vietnam which are seen as being in transition from centrally planned to more market dominated systems) tax shares actually declined in the 1990s, presumably reflecting the continuing realignment of public-private expenditure responsibilities. I do not discuss these countries further here.

⁶ For a more detailed review of tax levels and structures in countries grouped by income level, see, for example, Fox and Gurley (2005). (Population-weighted averages behave somewhat differently since larger countries like Brazil, India, and China dominate the results, but this is not relevant in the present context since tax policy decisions are made at the level of the nation-state.)

Table 1
Tax Revenues as a Percent of GDP^a

Country Groups	1970s	1980s	1990s	2000s ^b
Industrialized	30.1	33.7	35.5	33.4
Developing	16.2	17.3	17.0	17.0
Total^c	19.8	21.6	22.6	21.8

Source: Bahl (2006). Notes: (a) Decade averages. (b) Only limited data are available. (c) Total includes 'transitional' countries not included in the other two groups.

As Easterly (2009) has recently reminded us, there has never been a shortage of outside experts urging developing countries to make a 'big push' to break out of the low-income trap. This observation is certainly true with respect to taxation. In the early 1960s, for example, Nicholas Kaldor (1963), fresh from recent exposure to India's tax system, argued that for a country to become 'developed' it needed to collect in taxes something of the order of 25-30 percent of GDP.⁷ Even the more modest recent targets mentioned above seem unduly ambitious in terms of the historical record. A few fast-growing Asian countries such as India managed to reach and even exceed the UN-prescribed 4 percent of GDP increase in tax ratio in the early years of this century but it is by no means clear that such levels are sustainable.⁸ On the whole, fiscal inertia rather than fiscal growth appears to prevail, with many countries remaining for relatively long periods at more or less the same tax-GDP level.⁹

Of course, there is considerable variation within the diverse group of developing countries.¹⁰ While this is not the place to go into details, a recent analysis of the determinants of tax ratios suggests, among other things, that (a) developing countries that increased taxes did so largely in response to an increase in *per capita* GDP and (b) that there is at least some support for the argument that corruption and taxation are substitutes (Bahl 2006).¹¹ While there are some striking exceptions -- such as the case of Nicaragua mentioned later in this paper -- when it comes to tax levels in developing countries, on the whole less has been going on that may be apparent to eyes dazzled by the seemingly

⁷ Kaldor obviously did not agree with Colin Clark (1945) or, for that matter with Keynes, whom Clark (1977, 28) quotes as having, in private correspondence, agreed that "...as a practical proposition...25 per cent taxation is about the limit of what is easily borne."

⁸ As Poirson (2006) shows, general government revenues as a share of GDP have been surprisingly constant over time in India. Much of the increase in revenues in India in the early part of this decade reflected increased corporate taxes -- always a rather volatile revenue source, as many countries have recently again learned.

⁹ Often, even if the introduction of new technology or increased administrative effort initially appears to expand revenues, a variety of factors seems soon to dampen or even fully offset any resulting net increase in tax ratios: for an interesting discussion of the Mexican case, for example, see Martinez-Vazquez (2001).

¹⁰ The term "developing countries" encompasses such a wide spectrum -- from small fragile and fragmented post-conflict states like Liberia and Afghanistan to large well-established and rapidly growing countries like Brazil, China, and India -- that any generalization is likely to have many exceptions.

¹¹ The last point also receives some support from the analysis of Bird, Martinez-Vazquez, and Torgler (2008). Of course, one must always view cross-country regression-based interpretations with some skepticism (Easterly 2009).

endless changes of tax rates and tax legislation in many countries. To paraphrase a remark Galbraith (1964) once made, few of the irreversible transformative changes so often predicted as a result of this or that tax reform seem to have occurred. “Business as usual” is a better description than “tax reform” when it comes to tax reality in many countries.

Although tax ratios vary by income levels, even the poorest countries, although obviously more constrained than richer countries, have considerable discretion as to how much they raise in taxation. Both opportunity and choice affect tax levels. For example, countries with access to rich natural resource revenues, like Venezuela and Azerbaijan, tend to have higher tax ratios than otherwise comparable countries, though such revenues may also be highly volatile in response to commodity price changes. Many factors other than the level of per capita GDP affect tax ratios.

Tridimas and Winer (2004) usefully divide the possible explanatory factors into demand factors, supply factors and what they call ‘political’ factors that affect the way in which changes in demand and supply variables enter into and shape policy decisions; they also set out an interesting integrative model incorporating all groups of factors. Less ambitiously, Bird, Martinez-Vazquez and Torgler (2006), review a number of previous empirical studies of the traditional supply-side (‘tax handle’) variables, and then make new estimates with broadly similar results to most earlier studies along similar lines: per capita GDP and the non-agricultural share of GDP appear to be major factors explaining the size of public revenues in different countries. Like Baunsgaard and Keen (2005), Bird, Martinez-Vazquez and Torgler (2006) find that openness is no longer as significant an explanatory factor as in most earlier studies, presumably as a result of the substantial trade liberalization of recent years.

It is hardly a surprise to learn that the availability of an oil sector is important in explaining how much a country raises in revenue. However, telling a country that wants to raise its tax to GDP ratio to find oil is not very helpful. Supply-side studies make the problem facing most developing countries look more like a dilemma than a challenge: (1) Poor countries tax less because they have less to tax. (2) To develop their economy (and tax base), poor countries need to spend more on public infrastructure, education, and so on so. (3) Therefore they need to tax more.

One way out of this dilemma is to argue (as did Kaldor 1963) that the real reason countries do not tax more not so much because nature makes it impossible but because it is not in the interest of those who dominate their political institutions to increase taxes even to the extent ‘nature’ (and the world economy) permits. If this were the story, economists – who as a group seem somewhat professionally reluctant to leap to the revolutionary barricades – would appear to find it difficult to suggest an alternative solution.

Bird, Martinez-Vazquez and Torgler (2006) offer a somewhat more hopeful version of this story. Using several new ‘demand-side’ variables (such as quality of governance, inequality, size of informal sector, and tax morale), their estimates suggest

that to a significant extent tax levels reflect people's perception of the quality and responsiveness of the state. Kaldor (1963) was thus right in the important sense that countries that wish to tax more need to ensure their governing institutions facilitate the achievement of this goal. Doing so by such oft-suggested means as enhancing the rule of law, reducing corruption and the shadow economy and improving tax morale, is neither simple nor easy. Nonetheless, progress along these lines may be more feasible than attempting to, as it were, 'engineer' fiscal gains by altering the relative share of the non-agriculture sector in the economy or the weight of imports and exports in GDP.¹²

Tax Structures

The manner in which countries raise taxes differs as widely as the amounts they raise. The pattern of taxes in any country depends upon economic structure, history, the tax structures found in neighboring countries, administrative capacity, and political institutions. To illustrate, tax design is, for instance, strongly influenced by economic structure. Many developing countries have a large traditional agricultural sector that is not easily taxed. Many also have a significant informal economy that is largely outside the formal tax structure. As a result, the potentially reachable tax base usually constitutes a smaller portion of total economic activity than in developed countries.

Table 2
Tax Categories as Percent of Total Taxes^a

Income Taxes	1970	1980	1990	2000^b
Industrialized	35.5	37.8	38.6	53.8
Developing	29.6	28.6	27.6	28.3
Total	30.7	30.2	29.7	28.5
Consumption Taxes				
Industrialized	27.2	29.4	30.5	19.8
Developing	25.2	29.3	34.9	40.1
Total	25.3	28.9	34.2	39.0
Trade Taxes				
Industrialized	4.6	2.8	1.0	1.0
Developing	32.4	30.7	25.6	19.0
Total	25.2	23.8	18.2	14.1

Source and Notes: As for Table 1

¹² Nonetheless, as Bird (2007) emphasizes, tax bases are not simply 'given': to some extent they may be 'grown' – or destroyed – through the manner in which a given tax burden is collected. For example, taxes may discourage, or encourage, the 'formalization' of the economy, they may foster or discourage the growth of such 'tax handles' as imports, or they may be used to shape and direct economic growth into particular channels in a variety of ways and for a variety of purposes.

As Table 2 shows, consumption taxes are much more important in developing countries. On the other hand, income taxes are much more important in developed countries. For the whole sample studied by Fox and Gurley (2005), personal income taxes were a bit more important than corporate taxes (including extractive taxes) and VATs accounted for about 40 percent of consumption taxes, with excises being almost as important. In developing countries, however, the personal income tax plays a very limited role (Bird and Zolt 2005). Such countries have been hesitant to go too far in taxing labor in the formal sector, and labor in the informal sector is largely beyond the taxman's reach. The result is that, although personal income tax revenues are frequently three to four times corporate tax revenues in developed countries, in developing countries corporate tax revenues often exceed personal income tax revenues, sometimes by substantial amounts (Tanzi and Zee 2000). Even company income taxes have shown little growth in many developing countries as a result in part of continued and even increasing recourse to tax incentives as an instrument of growth policy (Keen and Simone 2004).¹³ An obvious reason why most developing countries reap little from either income or property taxes is their continued inability to administer such taxes effectively.

The differences in the relative use of income taxes are even more pronounced when examined on a regional basis. For instance, personal income taxes account for only about 1 percent of GDP in Latin America compared to (almost) 3 percent in Africa (Fox and Gurley 2005). Variations between countries within regions are even greater. In small island countries such as Barbados, for instance, international trade taxes may play an unusually important role. Trade taxes tend on the whole to be more important in poor countries, where they account for 24 percent of tax revenues compared to only 1 percent in rich countries. Trade taxes (mainly customs duties) decline steadily as countries become more developed.¹⁴ It is the poorest countries that have faced the greatest challenge in replacing such revenues in recent years as a result of trade liberalization. As Baunsgaard and Keen (2005) demonstrate, many of these countries have not been able to rise to this challenge.

On the other hand, the higher per capita income the more countries tend to rely on direct taxes (especially those on personal income) owing both to differences in economic structure and differences in collection capacity. Low-income countries raise much more of their revenue at the border where relatively few collection points need to be controlled. For the same reason, such countries are more likely to rely on excise taxes, such as those on tobacco and alcohol, for significant shares of their revenue. VATs, like direct taxes, tend to require not only more effective tax administration but also taxpayers who are more sophisticated -- both conditions more likely to exist in more developed countries.

¹³ Of course, as mentioned earlier, all generalizations about so heterogeneous a group are suspect. On one hand, as mentioned in note 7 above, corporate taxes accounted for much of the recent rise in India's tax ratio. On the other hand, in smaller countries the loss of as few as one or two firms may decimate the tax base.

¹⁴ Fox and Gurley (2005) report that the coefficient in a regression of per capita GDP on international trade taxes as a share of GDP is negative and statistically significant. An exception are the transitional countries of central and eastern Europe which -- although many of them fall within the low-income group -- have traditionally relied little on trade taxes (Martinez-Vazquez and McNab 2000).

Nonetheless, undoubtedly the most striking trend around the world in recent years has been the increase in the share of revenues generated by taxes on domestic consumption taxes. Particularly notable has been the widespread adoption of broad-based VATs (Bird and Gendron 2007).

However, the change in the composition of consumption taxes may mean less than at first appears for two reasons. First, although the manner in which consumption taxes are collected has changed, their relative importance has not. For developing countries as a whole, the rise in VAT has been almost exactly offset by the decline of trade taxes, while excise taxes have more or less maintained their position. Second, since a high proportion of VAT revenues are still collected at the customs house in many developing countries (Keen 2007), not even the composition of consumption taxation has changed all that much in reality.

How countries structure their tax systems depends also upon such factors as the need and desire for increased public services and the capacity to levy taxes effectively as well as the strength of preferences for such public policy goals as attaining a desired distribution of income and wealth and increasing the rate of growth. In a recent study based on observations for 100 countries over the 1975-92 period Kenny and Winer (2006) show that countries tend to utilize *all* tax bases (including some not normally included in 'tax ratio' studies such as seignorage) more as tax levels rise. To illustrate, if one compares OECD countries to Latin American countries, the latter collect less as a share of GDP from every tax source (Barreix and Roca 2006). More interestingly, Kenny and Winer (2006) also show that the degree of reliance on different tax bases over time increases more on bases that become relatively more important. For example, as oil production and prices increase, oil countries get more revenue from this source.¹⁵ Further, much as argued in the traditional 'tax handles' approach (Musgrave 1969) taxes on particular bases tend to increase when the administrative costs of imposing those taxes decline. For example, rising education levels lower the cost of imposing personal income taxes and are hence associated with more reliance on such taxes. Finally, Kenny and Winer (2006) suggest that a critical factor influencing tax structure choices is the extent to which reliance on particular tax sources can be translated into effective political opposition. For example, as Prichard (2009) details with respect to Ghana, fuel taxes may be derailed by strong opposition from well-organized taxi and truck operators. As Kenny and Winer (2006, 209) conclude, it seems clear that "...the onus should be on tax reformers ... to justify why any particular country's tax mix should be substantially altered in relation to its existing political equilibrium." I return to this important point later.

Developing countries obviously face difficult challenges in designing and implementing suitable tax systems. Many countries have large traditional agriculture sectors that everyone finds difficult to tax (Bird 1974). Other significant components of

¹⁵ In contrast, expanding trade in general has in recent years not been associated with increasing dependence on trade taxes (Baunsgaard and Keen 2005).

the potential tax base lurk in other equally “hard-to-tax” sectors ranging from small business and the informal economy to cross-border investments (Bird and Wallace 2004). However, tax yields should grow as openness and incomes increase since economic growth is both encouraged by and usually results in closer involvement with the international economy. As countries develop and become more open, the expanding mass modern production and consumption activities on which the tax systems of developed countries rest -- taxes on wages and personal income, on corporate profits, on value-added -- need to be captured in the tax base without either overstraining administrative capacity or unduly discouraging the expansion of such activities. This can be a fine line to draw and one that may be beyond the reach of some countries, not least because globalization may also exacerbate fiscal problems. The leading edge of growth -- outward-oriented development -- may all too easily become the bleeding edge of the fiscal system as it becomes more and more difficult to levy taxes effectively on capital income, thus potentially exacerbating internal inequalities and political pressures on the tax system. Similarly, although developing countries in the past have often relied heavily on border taxes on international trade, this tax base too is becoming increasingly hard to exploit in the face of pressures for trade liberalization. Life is not easy for those concerned with taxation issues in developing countries.

Over the past 50 years, academic research and international institutions have issued many policy prescriptions for economic growth (Easterly 2002). In rough chronological order, the advice has included increased capital investment, improvements in education, population control, trade and capital market liberalization and reduction of government controls on market activities. Each has in turn been marketed by some as a “silver bullet” that would result in improved economic performance. Unfortunately, none of these cures has worked as advertised. Nor is there any magic tax strategy to encourage economic growth.

On the whole empirical work on the impact of tax *levels* on growth in developing countries has come to no firm conclusions. Even endogenous growth models that allow for the effects of tax policy on growth do not give a consensus answer about whether higher taxes crowd out faster rates of economic growth (Mintz 2003). It is difficult to separate the effect of the level of taxes from the level of expenditures and the budget balance. Not surprisingly, different model specifications produce different results. The effect of tax *structure* on economic growth is an equally unresolved issue (OECD 2008). In theory, of course, non-neutralities in tax structure impose a drag on the economy. Using computable general equilibrium models, the welfare cost of some taxes in some developing countries have been estimated to be more than 100 percent of the amount of tax raised (Rutherford, Light, and Barrera 2005). Others point to the stimulus effects of tax rate reductions. The evidence here is also not clear. Ivanova, Keen and Klemm (2005), for example, find no evidence of a supply side effect from Russia’s rate reduction and adoption of a flat rate income tax, but Martinez-Vazquez, Rider and Wallace (2008) do find evidence of a labor supply effect.¹⁶ As Lindert (2003) shows in historical context, the effects of taxes in particular country settings often depend on very detailed

¹⁶ For a recent review of the Eastern European experience with flat taxes, see Gray, Lane and Varoudakis (2007)

characteristics of tax design and implementation that are not easily captured in econometric models.

Some countries with high tax burdens have high growth rates. Some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in the United States over the last 50 years, for instance, shows that the U.S. has had its greatest periods of economic growth during those years where the tax rates were the highest (Slemrod and Bakija 1996). This does not mean that high tax rates are the key to economic growth: growth rates might have been even higher in years with high tax rates if the rates had been lower. But it does provide yet one more indication that there is still much that we do not understand about the relation between taxes and growth. Indeed, no matter how the data are manipulated, it usually turns out to be difficult to detect any economically significant relationship between variations in either tax levels and tax structures over time and growth rates either in OECD countries or in developing countries.

Tax Systems

Of course, many important aspects of tax systems are not directly visible in the recorded revenue figures. Tax laws emerge from a political process and produce revenue only when implemented. What *can* be done to a considerable extent determines what *is* done in any country. In many developing countries, as already mentioned, there is a large traditional agricultural sector that is not easily taxed.¹⁷ Often there is also a significant informal (shadow) economy that is largely outside the formal tax structure (Alm, Martinez-Vazquez and Wallace 2004). To some extent the size of the ‘untaxed’ economy may itself be a function of the design and implementation of the tax system. For example, the high social insurance tax rates levied in some countries may discourage employers from reporting the extent of employment, encourage the under-reporting of wage levels, and foster the development of the informal economy. If the resulting lower tax revenues lead governments to raise tax rates still further, incentives to evade taxes will be exacerbated. Such problems are more difficult to cope with when a country’s administrative capacity is limited, as it is in most low-income countries.

The importance of good administration has long been as obvious to those concerned with tax policy in developing countries as has its absence in practice. The real tax system people and businesses face reflects not just tax law but also how that law is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency (Tanzi 1991). Tax administration is too important to policy outcomes to be neglected by tax policy reformers.¹⁸ Unfortunately, tax administration is a difficult task even at the best of time and in the best of places, and conditions in few developing countries match these specifications. Moreover, administration is inherently country-specific and

¹⁷ The special problems of taxing agriculture are not discussed here: a useful recent review is Khan (2001); the administrative aspect of agricultural taxation is discussed in some detail in Bird (1974).

¹⁸ As McLaren (2003), p. v, puts the point: “...optimal policy requires simultaneous consideration of the design of the tax code and of the administrative structure created to enforce it.”

surprisingly hard to quantify in terms of both outputs and inputs. The best tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalizing noncompliance; tax administration depends as much or more on private as on public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of a given administrative effort. All this makes tax administration a complex matter.

Nonetheless, in a very real sense, "tax administration *is* tax policy" (Casanegra de Jantscher 1990, 179). *How* revenue is raised - the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare - may be equally (or more) important as *how much* revenue is raised. Private as well as public costs of tax administration must be taken into account. Attention must be paid to the extent to which revenue is attributable to enforcement (the active intervention of the administration) rather than compliance (the relatively passive role of the administration as the recipient of revenues generated by other features of the system).¹⁹ Assessing the relation between administrative effort and revenue outcome is by no means a simple task. Work on this subject has barely begun in developed countries (OECD 2009), and despite a few pioneering efforts (Gallagher 2004) we know almost nothing about this critical dimension of taxation in developing countries.²⁰

Much the same can be said of an even more fundamental determinant of tax system change – the political economy of taxation. Those who design and implement tax systems, like those who try to escape them, probably consider themselves to be eminently 'practical' people responding to the world around them as they see it. Keynes (1936, 384-85) once said that "practical men, who believe themselves to be quite free from any intellectual influences, are usually the slaves of some defunct economist....soon or late, it is ideas, not vested interests, which are dangerous for good or evil." This dictum both unduly flatters economists and gives too little weight to interests and other factors. Tax policy is shaped not only by ideas and vested interests but also by changing economic conditions, by administrative constraints and technological possibilities, and, especially, by the political institutions within which these factors affect policy decisions.²¹

Developing countries are no different than others: ideas, interests, and institutions determine tax policy. The best tax system for any country is presumably one that reflects its economic structure, its capacity to administer taxes, its public service needs, and its access to such other sources of revenue as aid or oil. In addition, it must also take into

¹⁹In what is still one of the few studies of how tax administrations actually function in developing countries, Radian (1980) emphasizes the extent to which such administrations tend to be passive recipients of funds rather than active collectors. Radian labels this important aspect of tax administration "telling" as opposed to "collecting." Rather than go out and look for tax revenues, such administrations tend to sit behind a counter and wait for people to bring money to them. As I note later, the facilitating and monitoring of such "quasi-voluntary" compliance (Levi 1988) is critically important for more than revenue reasons.

²⁰For an earlier detailed review of the critical administrative dimension of tax policy, see Bird (2004).

²¹For an interesting recent study along these lines for Latin America, see IDB (2006). Tax technology is not discussed here, but see Bird and Zolt (2008).

account such nebulous but important factors as ‘tax morale’, ‘tax culture’, and, perhaps above all, the level of ‘trust’ existing between people and their government.²² Tax policy decisions are not made in a vacuum. Nor are tax systems implemented in one. The taxes that are adopted in a country and how they are administered are always and everywhere both path-dependent and context-specific. They reflect the outcome of complex social and political interactions between different groups in society in an institutional context established by history and state administrative capacity. Like tax administration, tax politics thus deserves close attention by those interested in improving tax policy.

Trends in Tax Research

Until recently, however, few economists devoted much thought to either the administrative or the political dimensions of taxation. Understandably, they instead approached research on taxation almost entirely from the disciplinary base of mainstream economics. What lessons has this impressive body of research suggested in recent decades for those concerned with improving tax policy in any country?

Income vs. Consumption

As Auerbach (2009) notes, the accepted academic view of good tax policy, circa 1970, was approximately as follows:

1. The ideal tax was a broad-based income tax with progressive rates.
2. Capital gains were properly taxed under such a tax. (Practically, however, gains could only be taxed on a realization basis, with the resulting lock-in effects often being mitigated by a reduced tax rate.)
3. Integrating corporate and personal income taxes was seen as a way of making both the decision to incorporate and the debt-equity choice more neutral. (Usefully, dividend relief would also dampen the distortion from lower capital gains tax rates.)
4. The dominant approach to taxing cross-border income flows was capital export neutrality although a limited case could also be made for capital import neutrality.

This concise summary seems to me to tell the story of the 1960s: it was all about the income tax, at least in English-speaking countries. Indeed, the report of the Canadian Royal Commission (1966) at the time was called ‘a landmark in the annals of taxation’ by Harberger (1968) precisely because it was considered to be the most detailed attempt to turn these ideas into practical policy recommendations.

²² For introductory discussions of the three factors listed in the text, see, respectively, Frey (2002), Edling and Nguyen-Thahn (2005), and Bergman (2002) as well as the case studies in Brautigam, Fjeldstad, and Moore (2007).

Over the last few decades, however, many of the policy verities listed above were overturned.²³ New and different guidelines for tax policy-makers emerged from tax research. Most importantly, taxing consumption became intellectually respectable. Indeed, to many current economists – if as yet few policy-makers – a good tax system is likely to be one based on taxing consumption. Indeed, much of the (largely American) theoretical literature on this subject in the 1980s and 1990s focused on how to design and implement an ‘optimal’ progressive consumption tax to replace the income tax, although no one has actually done this, anywhere.²⁴ Recently, the earlier enthusiasm for such a wholesale tax substitution seems to have died down even in theoretical circles. However, an important residual effect remains: few economists are now keen on taxing capital income at high rates, if at all.

Two main policy-relevant outcomes of recent tax research stand out. First, the world-wide expansion of VAT probably benefited to some extent by the removal of (most) professional economists from the list of opponents of general consumption taxation. Curiously, the main practical result of the prolonged theoretical discussion about ‘new’ forms of progressive direct consumption taxes may thus have been to foster a better – but still not very (if at all) progressive – indirect consumption tax.²⁵ Second, in the eyes of an increasing number of economists, it is becoming more difficult to make a good case – other than the practical difficulty of distinguishing one from the other – for taxing income from labor and income from capital identically.

What does this mean for developing countries? Replacing income taxes by progressive consumption taxation in such countries was – as efforts inspired by Kaldor in India and what was then Ceylon (now Sri Lanka) showed long ago (Goode 1961) – never a real possibility. In the end, in addition to making VAT more acceptable, the main practical impact of all the fuss about potential new forms of direct consumption taxes may turn out to be to revive income taxes in developing countries by turning them into something closer to dual taxes, with mildly progressive rates on wages but largely flat taxes on capital (Bird and Zolt 2009).

An additional important conclusion from recent research is that, as Auerbach (2009) makes clear, countries can no longer treat the ‘international’ dimension of tax policy as some sort of simple ‘add-on’ to domestic tax policy. In the more open international capital market of recent decades, all countries are to some extent in competition for capital and need to factor this reality into their income tax systems. Unfortunately, as Auerbach (2009, 22) notes, tax research has as yet produced “...no simple norms that tell us what a system of international taxation should look like.” While

²³ For example, Auerbach (2009) notes that recent research raises questions about the strength of the traditional case for corporate-personal tax integration and also shows that taxing capital gains on an accrual rather than realization basis appears to be technically feasible. However, no one has yet managed to tax accrual gains and the few partial attempts made to do so (e.g. in Canada in the 1980s) soon vanished in the face of popular indifference and interested opposition. One cannot, it seems, ignore the strong perceptual barriers to accrual taxation that arise from liquidity concerns and especially from the way in which people ‘tie’ taxes to the specific object taxed.

²⁴ For a useful recent review of the literature on direct consumption taxes, see McLure and Zodrow (2007).

²⁵ For a review of the issue of VAT progressivity in developing countries, see Bird and Gendron (2007).

this is not a subject that can be explored in depth here, it seems unlikely that answers to the intractable problems facing international tax designers lie in either the traditional source or residence principles (Bird and Wilkie 2000) or for that matter in such new ‘principles’ as ‘capital ownership neutrality’ (Desai and Hines 2003). Some (Tanzi 1995) have suggested that what the world may need to grapple with the tax problems of globalization is some kind of formal “International Tax Organization” with at least some enforcement powers. However, this seems to be several giant steps closer to “world government” than anyone is likely to go in the near future – or perhaps should go at all. Instead, those looking for solutions to the international tax dilemma should pay more attention in the international context to the institutional setting from which, if we are persistent, reasonable (that is, acceptable) solutions may eventually emerge (Bird and Mintz 2003). When principle provides no answer, practice will eventually do so in one way or another. As Babcock and Loewenstein (1997, 122) put it: “...there are many problems that people are unable to solve in the abstract, but are able to solve when placed in a real-world context.” International taxation may be one such problem

Optimal Tax Theory

An additional characteristic of the “1970” tax setting noted by Auerbach (2009) is that second-best theory made it difficult to decide whether one could or should correct certain distortions or to carry out partial reforms. Fortunately those thus baffled were soon saved, or so it seemed, by the debut of optimal tax theory (OT). A recent paper by Mankiw, Weinzierl and Yagan (2009) helpfully sets out a number of lessons that policy-makers may derive from OT, including the following:

1. Marginal tax rates on higher incomes should be lowered.
2. More linear (flatter) tax rate schedules might be better.
3. Taxes should vary with personal characteristics as well as income.
4. Only final goods should be taxed, and usually they should be taxed uniformly.
5. Capital income should be untaxed, at least ex ante.

Mankiw, Weinzierl and Yagan (2009) conclude that policy-makers in the OECD countries seem to have heard at least part of the OT siren call. With respect to the personal income tax, for example, although both the theory and the evidence on the gains from doing so remain ambiguous, many countries, developed and developing alike, have lowered marginal tax rates on high income recipients.²⁶ In Latin America, for example, the average top personal income tax rate fell from 51 percent in 1985 to 28 percent in 2003 and the average corporate rate from 41 to 28 percent (Lora and Cardenas 2006).

High marginal tax rates (MTRs) clearly induce a variety of changes in the behavior of taxpayers, with resulting economic costs. Tax-induced changes may include changes in hours worked and in labor force participation, the substitution of non-taxable for taxable consumption, changes in the timing of income realization, changes in the form

²⁶ For a useful recent compilation of the evidence, see Peter, Buttrick and Duncan (2009).

of compensation (including incorporation), use of deferred compensation and other tax shelters, and increased evasion.²⁷

These statements may be uncontroversial to economists. Unfortunately, they are also not particularly useful to policy-makers. OT makes it clear that a high MTR is more costly when applied to a tax base that is more responsive to tax rates — when, for example, affected taxpayers may easily substitute from paid work to unpaid family care, or from conventional employment to activities in the less-taxed informal sector, or they may even move to another country. Such behavioral responses to taxation can be usefully summarized in the “elasticity of taxable income” (Feldstein 1995) — the average percentage decrease in a taxpayer’s taxable income due to all behavioral responses when the taxpayer’s marginal share (one minus the marginal tax rate) is decreased by 1 per cent. Examining the effects of the 1986 U.S. tax reform on a sample of taxpayers, Feldstein (1995) estimated the elasticity of taxable income to be quite large, with preferred estimates ranging from 1.0 to 1.5. To put these estimates in perspective, note that unitary elasticity implies that government revenues would reach their maximum level at a tax rate of 50 per cent; further tax increases would actually decrease revenues. This approach provides a useful way to help make old arguments about efficiency more meaningful and palatable to policymakers. As Mankiw, Weinzierl and Yagan (2009, 120) put it, “though the optimal tax literature has not conclusively answered the question of how far from flat is the optimal tax policy, policymakers seem to have decided that flatter is better.” However, although income tax rates have come down around the world, as Mankiw, Weinzierl and Yagan (2009) themselves conclude there is little evidence that the structure of MTRs accords with what analysis suggests.

Moreover, although most OECD countries have varied tax schedules (including direct income-related transfers as well as refundable tax credits) that to some extent take into account such non-income characteristics as age, parenthood, and disability, most have been reluctant to pursue ‘tagging’ any further. Mankiw, Weinzierl and Yagan (2009) suggest that one reason for this reluctance is perhaps because criteria other than ‘ability’ such as benefits received and horizontal equity are considered relevant. Not only are they probably correct in this suggestion but, as is discussed further below, policy-makers are equally correct to take such criteria into account – regardless of whether they fit neatly within the OT framework. The inability of tax researchers to provide clear guidance on such basic questions of income tax design as the appropriate tax unit (Auerbach 2009) is just one more example of the limitations of the OT approach as a guide to good tax policy. “There are more things in heaven and earth, Horatio, than are dreamt of in your philosophy” as Shakespeare once put it.

Turning to consumption taxes, it is not surprising that authors who have diligently toiled in the OT vineyard suggest that “...the large and growing importance of value-added taxes suggests that policymakers have internalized certain lessons of optimal tax theory with regard to commodity taxation (Mankiw, Weinzierl and Yagan 2009, 20).” It seems more plausible, however, to suggest that VAT has swept the board for a number of reasons that have little, if anything, to do with the ‘internalization’ of OT lessons. In

²⁷ The next paragraph draws on Bird and Smart (2001).

what is now the European Union, for example, the rationale for adopting the VAT was primarily to deal with troublesome cross-border trade issues. In most of the rest of the world, the rationale was in part the reputed administrative advantages of VAT compared to other forms of sales taxes, in part the desire of the IMF and other external advisers to increase the income-elasticity of consumption taxes, and most recently the need to accommodate WTO-linked trade liberalization.

Similarly, while Mankiw, Weinzierl and Yagan (2009, 22) seem a bit disappointed when they conclude with respect to OECD countries that “both statutory tax rates on capital and measures of effective tax rates remain far from zero, the level recommended by standard optimal tax models,” a few pages later they note more cheerfully that “...some trends in tax policy look like at least partial victories for optimal tax theory. Perhaps the most important is the worldwide trend toward reduced taxation of capital income....(p. 25).” Again, one may doubt the extent to which this trend is attributable to the slow inculcation of OT into the minds of policy-makers. A much more important factor has surely been the much discussed ‘globalization’ of international capital markets and the accompanying regional and international competition for capital that was such a marked factor shaping tax policy prior to the current crisis.

Some years ago, in a review of Newbery and Stern (1987), the first major attempt to apply OT to developing country taxation, McLure (1990, 431) noted that “...graduate students, who are notably inept at seeing the forests of reality while surrounded by the tall trees of economic theory...should be aware that there is much more to the analysis of taxation in developing countries than the sophisticated economic theory developed in this impressive volume.” Mankiw, Weinzierl and Yagan (2009, 2) correctly recognize that “where large gaps between theory and policy remain, the ...question is whether policymakers need to learn more from theorists, or the other way round.” With respect to developing countries, the choice seems clear: tax researchers need to understand the real constraints and objectives facing policymakers before offering them pre-cut solutions to what researchers think are their problems. As Slemrod (1990) and others have argued, for example, it is critical to incorporate administrative constraints into OT analysis. Moreover, as Moore (2007) and others have said, we also need to take explicitly into account the extent to which such concerns as horizontal equity may reflect, and affect, the basic ‘state-building’ function of taxation in developing countries.

This point comes out particularly strongly with respect to the increasingly sophisticated OT theory that has recently been developed in a stochastic and dynamic analytical framework. Work along these lines is complex and, as Mankiw, Weinzierl and Yagan (2009) note, as yet yields few clear messages for policy-makers. Nor does it seem likely to do so in the near future if ever for policy-makers in developing countries. Such countries are populated not only by the *homo economicus* of mainstream neoclassical economics -- graduates, as it were, of “Max U” (the school of utility maximization) -- but also by the very different people whom Cullis, Jones and Lewis (2008) call *homo realitus*. This being -- the object of much recent study in behavioral economics -- satisfices within bounded rationality and is sensitive to framing effects, reference points, preference interdependence and other characteristics that are troublesome from a Max U

perspective.²⁸ To further complicate the story, developing countries presumably live in the hope that lurking about the scene somewhere there may even be a few specimens of the recently rediscovered creature that Bronk (2009) calls *homo romanticus* – essentially the imaginative and entrepreneurial change agent central to Schumpeter's (1934, 1942) development model.²⁹ Not only is the world within which tax policy decisions are made complex; so are the people who make, and react to, such decisions.

What Have We Learned?

The two most important changes in tax systems in recent decades have been the introduction of the VAT and the general lowering and flattening of statutory income tax rates. Economic research has undoubtedly contributed significantly to both these important changes in taxation. However, countries have not done these things because economists produced persuasive theories or empirical evidence that it would be good to do them. On the contrary, fiscal history suggests that much tax research takes place precisely because countries change tax policies for their own reasons.³⁰ Often, tax researchers are not so much leading the reform elephant as mopping up behind it. VAT, for example, was developed in France and then adopted in Europe as a better way to administer a general consumption tax, particularly for cross-border trade. Countries lowered and flattened income taxes both because more people rose into tax brackets formerly occupied, if at all, by a few rich people and also because of perceived international competition for capital and to some extent even for highly-skilled workers.³¹ Economists then came along and tidied up and rationalized in terms of accepted theory developments that had to some extent already occurred in the real world.

Even when policy-makers buy economic arguments and evidence, they often do so for their own reasons, not simply because the economic doctor tells them it would be good for them. To illustrate how little research usually has to do with policy consider, for instance, property taxes in the United States. Research on this tax has long been a major industry in that country.³² Nonetheless, it is hard to detect much, if any, effect on actual tax policy as a result of all this research. None of the many and sometimes major changes that have taken place in property tax policy in recent years seem to reflect much, if any,

²⁸ See the useful recent surveys by DellaVigna (2009) and Congdon, KKling, and Mullainathan (2009).

²⁹ If such beings manifest themselves, countries must also pray that they appear in their 'creative destruction' mode, tearing down the old to build up the new, rather than in the 'destruction for the sake of destruction' mode of 'romantic revolution' that has played havoc in the past in some countries. For a revealing contrast of the two 'romantic' modes, see Bronk (2009); see also the interesting intellectual history of the impact of the left in Latin America in Castañeda (1994).

³⁰ At least this is my reading of the tax history set out in such sources as the magisterial survey by Webber and Wildavsky (1986), the country studies by Daunton (2001, 2002), Smith (2004), Gillespie (1991), Steinmo (1993), Brownlee (2007), and Lindert (2003), and the recent overview of Latin America in IDB (2006).

³¹ The latter argument was, for example, the dominant rationale given for lowering income tax rates in the Carter Report (Royal Commission 1966).

³² Witness the major survey papers by Zodrow (2001) and Fischel (2001): the rate of production has not slowed down, as the references in Augustine et al. (2009) demonstrate. The recent kind words about the growth effects of reliance on property taxes in OECD (2008) are unlikely to result in more use of this tax.

concern for what researchers have found. For example, it is impossible to find any support in the literature for the increasingly common policy of imposing arbitrary caps and limits on property taxes. Property tax research and property tax policy appear to be activities carried out by different people in different rooms who do not communicate well with each other.

Excise taxes are another ancient tax that still generates significant revenues in many countries. Countless studies have considered the efficiency effects of taxes on alcoholic beverages and tobacco. Again, however, such studies have had little perceptible effect on either the level or structure of these taxes.³³ Much the same is true with respect to taxes on vehicles and fuel, despite the substantial economic literature suggesting alternative designs of these levies on efficiency grounds. Perceived effects on equity and politics almost always trump efficiency analysis even if – unusually -- the latter is presented to policymakers in both language and a context to which they can relate.

Does this rather negative appraisal of the effects of tax research on tax policy mean we should give up? Of course not. First, it is essential, to paraphrase Harberger (1971), that economists continue to carry the flag of efficiency proudly into battle. If we do not, no one else is likely to do so, and efficiency really does matter...a lot, even though, as suggested earlier, more should be done in expanding the normative perspective as suggested in some of the recent behavioural economics literature (Congdon, Kling and Mullainathan 2009) as well as, in some respects the positive perspective – for example, in terms of the probably much higher marginal cost of public funds (MCPF) in the context of developing than of developed countries (Estache and Wren-Lewis 2009). Second, the research glass is at least half full from a policy perspective. The downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by the increasing research measuring the distortions caused by high marginal tax rates. Equally, the widespread adoption of VAT is probably due at least in part to acceptance of the economic argument that this form of sales tax is less economically distorting.³⁴ However, economists should not flatter themselves too much: equally convincing (or

³³ Cook (2007) provides a recent review of both research and policy on alcohol in the U.S. For a more general overview of excise tax research and policy, see Cnossen (2005). The important interaction between tax and regulatory policy is one aspect that clearly needs more attention: the theoretical framework is set out in Christiansen and Smith (2009).

³⁴For example, Bird and Smart (2001) suggest that in the case of Canada economists did play an important role in persuading the government to move from the archaic manufacturers sales tax to the new VAT (the Goods and Services Tax, GST). Indeed, since reducing economic distortion was the only clear gain from introducing the GST, it may be argued that the government that did so was the first — and probably the last — in Canadian history willing to sacrifice itself on the altar of economic efficiency. Of course, much of the public discussion of the GST in Canada as in other countries focused not on efficiency issues, but on equity issues. Two-handed economists argued on both sides of this issue; again, however, one might argue that their contribution in showing, on the basis of plausible assumptions, that the tax was not seriously regressive helped carry the day. All in all, regardless of what one may think of the GST, its adoption stands as probably the single most important example to date of the influence of economists on Canadian tax policy. For an interesting discussion of the political dimension of the VAT choice in a number of developed countries, see Eccleston (2007).

unconvincing) economic studies of the damage done by poorly-designed corporate, excise, property, and payroll taxes have not met with a similarly receptive audience.

Both the broad-based low-rate (BBLR) approach to income taxes and the VAT as a superior sales tax and the best way to replace trade taxes were extensively marketed in the developing world by fiscal missionaries from the IMF and elsewhere.³⁵ Not all such missionaries had to sell, however, found such a receptive market. The relative success of the two ‘big’ changes mentioned above may well lie at least to some extent in the fact that, arguably, they coincide with elite interests. By definition, elites pay most of the income taxes in developing countries. Consequently they benefit directly from reduced and flatter income taxes. Elites do not pay most VAT. However, they control the companies that act as collection agents for this tax, and it is generally in their interests to extend the tax base as far as possible in order to draw into the tax net as much of their ‘informal sector’ competition as possible.

Distribution Matters

A number of less bleak lessons may also be drawn from the broader post-war experience. One is that tax economists who wish to influence public policy must pay more attention to the issues that motivate policymakers – both officials and politicians—as well as people more generally, even if this means that they may pay somewhat less attention to producing publishable academic papers. This is not a plea for “dumbing down” policy analysis. On the contrary, in many ways – certainly from the perspective of improving tax policy outcomes -- it is a plea to smarten it up.

To illustrate, analysis that assumes distributional considerations are either unimportant or can easily be accommodated by (usually unspecified) adjustments somewhere else in the tax-transfer system simply does not resonate in the policy context of most countries. Distributional issues matter in tax policy. Indeed, they often dominate in the minds of those who shape that policy. However, it is unlikely that the principal concern is the sort of broad poverty-alleviation goal beloved by many academic writers on development. Policy-makers may talk about poverty-alleviation and more egalitarian income distribution. In reality, however, their concerns about policy outcomes are usually much more narrowly focused. How will this region or locality be affected relative to that one? Will home-owners be disadvantaged or benefited? How will children be affected? Older people? What will be the effects on farmers and the rural sector? Will this industry be better or worse off?

Such questions are seldom considered in mainline academic research, but they are frequently the meat and bones of actual policy decisions. To resonate in policy circles, research thus needs to speak to such questions, whether or not they fit easily or at all within the accepted disciplinary research model. As the fascinating story of the (transitory) death of death taxes in the U.S. a few years ago shows, one good story – even if false -- can easily trump 100 sound econometric studies (Graetz and Shapiro 2005). If

³⁵ On VAT, see Bird and Gendron (2007) and on the BBLR reforms, see Bird (2008).

economists want their research to be taken seriously, they too need to be able to tell good stories that relate to the concerns that people have – regardless of whether those concerns are seen as central, or even acceptable, in academic circles.

Fairness is always a key issue in designing any tax regime. Of course, what is considered equitable or fair by one person may differ from the conceptions held by others. Some may stress horizontal over vertical equity, for example, as OECD (2006) suggests is increasingly true in developed countries and as Boylan (1996) and Bergman (2003) have suggested is also the case in Latin America. Others may tilt the balance the other way, as ‘progressive’ thinkers have long done. Broadly, *horizontal equity* requires those in similar circumstances to pay the same amount of taxes, while *vertical equity* requires appropriate differences among taxpayers in different economic circumstances. Those who have the same ability to pay should bear the same tax liability; equally, fairness would seem to require those taxpayers with greater ability to pay to pay relatively higher taxes. Both concepts have considerable appeal. Unfortunately, neither concept is very useful in actually setting up a tax system.

Chu, Davoodi, and Gupta (2000) surveyed 36 studies of tax incidence in 19 different developing countries: 13 found the tax system progressive, and 7 each found the tax system proportional and regressive; the others had mixed findings or insignificant effects. Most of the reported progressivity came from income taxes. Income taxes in most developing countries are likely progressive to some extent. Indeed, to the extent income taxes do not impinge on the poorest people – those outside the market sector – they are bound to be progressive. Even within the taxed sector, progressive rates mean that the impact of the tax is progressive at least within the group of those who must pay tax on most of their income-- for example because they receive it in the form of wages from a public sector employer. In most developing countries, however, little if any tax is collected from capital income or self-employment (mixed) income and that little is most unlikely to be distributed very progressively.

Does tax progressivity matter for distributional policy? Harberger (2006) argues it does not matter much: insofar as government policy affects the distribution of income and wealth, providing education (even when financed from regressive taxes) is much more powerful than taxing the rich. Even in a relatively advanced country like Chile with an unusually well-developed and effective tax administration the progressivity of the income tax has no significant influence on distributional outcomes (Engel, Galetovic and Raddatz 1999). Although one may argue that progressive taxes share the burden of government more fairly, there are few poor countries in which even the most progressive taxes on the rich can, even ignoring incentive effects, make much difference to the poor (Ravaillon 2009). It was not by taxing the rich but by taxing the growing middle class that developed countries ‘grew’ large states (Lindert 2003). In notoriously unequal Latin America, for example, income taxes only began to be relatively efficient and effective revenue raisers as (some) countries have begun to bite into the middle class, essentially by combining reduced top rates with lowering the level at which those reduced rates come into play (Lora and Cardenas 2006).

The general failure of tax economists to say anything that policymakers consider useful about distributional issues has often relegated them, and their evidence, to the sidelines in policy discussion. Distributional studies are out of fashion in academic circles. Such studies are often both conceptually and empirically difficult and very model-specific. Nonetheless, since equity continues to lie at the heart of public economics, unless and until economists can deal more explicitly and satisfactorily with this issue, their success record in influencing tax policy seems unlikely to improve much.³⁶

In addition, if one wishes to affect policy, one must write in a way, and in a forum, that will come to the notice of policymakers. A few prominent academic economists have not hesitated to engage in public discussion of key policy issues, attempting to convince wider audiences of the cogency and importance of the economic analysis of taxation. Such involvement in policy is usually off limits for those who aspire to tenure in an academic economics department, however. Nonetheless, economists concerned with the persistence of “bad” policies unsupported by any coherent reasoning or cogent empirical evidence need both to communicate with policymakers and to engage with the (small) informed public with which policymakers interact.

Tax policy is not just about economics but about politics. To understand how economic analysis of tax issues is perceived in any country and to affect policy outcomes one must understand the political as well as the economic factors that shape policy decisions and policy outcomes in that country. The level and the structure of taxation reflect deep-seated institutional factors that, in the absence of severe shocks, do not change quickly. Tax policy decisions are not made in a vacuum. Nor are they made by a benevolent government. They reflect the outcome of complex social and political interactions between different groups in society in an institutional context established by history and state administrative capacity. Taxation is not just a means of financing government; it is also a very visible component of the social contract underlying the state. Citizens are more likely to comply with tax laws if they accept the state as legitimate and credible and are thus to some extent both willing to support it and afraid of what will happen to them if they don't. Tax policy changes thus depend largely on how different political groups perceive proposed changes and how they react to these perceptions. As Lledo, Schneider, and Moore (2003) put it, any major tax reform is thus always and everywhere “an exercise in political legitimation.” Those who will have to pay more must be convinced that they will get something worthwhile for their money. Those who do not want to pay more must not be able to block reform and, in the end, must be willing to go along without taking to the hills in revolt or fleeing the country.³⁷ Those within government and in the private sector who have to implement reform must support it or at

³⁶ For example, although surprisingly few tax policy economists seem even to be familiar with Rawls (1971), they would do well to think more deeply about some of the important, and difficult, issues raised in Sen (2009)'s recent impressive reconsideration of the idea of 'justice.'

³⁷ Or perhaps creating their own country: for example, Rabushka (2008, 868) concludes his recent exhaustive recent review of taxation in colonial America with the unequivocal statement that “The American Revolution....was a tax revolt, first and foremost.”

least not actively sabotage it. And of course politicians have to see sufficient support to warrant putting reform not only on the agenda but on the ground.

Political scientists have recently rediscovered that taxes matter and are now doing some of the most interesting and promising work on tax policy in developing countries.³⁸ Economists too need to pay more attention to the question of how tax policy is (and might be) formulated in democratic and non-democratic settings alike if they expect policy-makers in developing countries to make better use of economic evidence in developing and implementing tax policy.

Accountability and Visibility

As an example of the importance of getting the politics of taxation right, consider an apparently minor question about VAT. Should VAT be quoted separately from prices? This question does not have a simple answer.³⁹

Retail sales taxes (RSTs) like those in most U.S. states are invariably stated as a separate explicit charge imposed on the posted price when the consumer arrives at the cash register. While this process is cumbersome and unwelcome – no one ever has the correct change ready! – the very fact that it is annoying may be considered good for democracy if one believes that citizens should be fully aware of the cost of government. However, such transparency also makes it more difficult to increase taxes because everyone is instantly aware of increases. In contrast, in most countries VAT is included in posted prices and hence is not immediately obvious to the consumer at the point of sale (although it may be stated explicitly on the cash register statement or invoice). Visible, or invisible: does it matter?

While there have been few serious studies of this issue,⁴⁰ it is intuitively plausible that it should be easier to introduce (or increase) a tax if people are not painfully reminded that the tax exists by having to add it separately to the quoted price every time they buy something.⁴¹ Moreover, if VAT is relatively invisible it may be easier to have a

³⁸ For a good sampler, see Brautigam, Fjeldstad and Moore (2007). Economists have of course also recently done excellent work on the political economy of taxation, as summarized a few years ago by Persson and Tabellini (2000, 2003) and since developed further by them and others. For the most part, however, this work understandably plays to our disciplinary expertise in model-building and econometrics. Apart from a few economic historians (such as Lindert (2003)), however, so far neither development nor public economists have contributed relatively much to the detailed and nuanced country-specific analysis that seems most needed to make progress in this area despite the promising theoretical frameworks set out by such authors as Hettich and Winer (1999) and Wintrobe (1998).

³⁹ This discussion draws heavily on Bird and Gendron (2007).

⁴⁰ For two early studies, see Tanzi (1970) and Bird (1982). Recently, under the name of “saliency” theoretical and empirical literature has finally begun to take this important characteristic explicitly into account: see especially (Chetty, Looney and Kroft (2007), although it should be noted that my argument here is, in a sense, the reverse side of theirs.

⁴¹ One reason some conservatives in the U.S. have resisted VAT and argued for replacing the income tax by a separately-quoted national RST is that they think a ‘hidden’ VAT would lead to a larger government – a belief that evidence from developed countries supports to some extent (Keen and Lockwood 2006)– while

better, broader tax base, for instance, by taxing a wider range of services. A broader base is undoubtedly more desirable on both administrative and economic grounds than one eroded by popular resistance to taxes on food, on medicines, on school books and so on. On the other hand, if people should know what they are paying for what they are getting from government, then even if the price of more transparency is a less perfect VAT, the price might be considered worth paying.⁴² Given these conflicting arguments, it is striking that almost every country with a VAT has chosen to hide the tax from the public.⁴³ This outcome is understandable from the standpoint of those who make the decisions. However, hiding the tax bill does not seem, on its face, to be a particularly attractive way to build a sustainable democratic consensus in support of fiscal equilibrium.

Such issues need to be considered carefully in formulating tax policy. Marketing matters. Those who want serious reform in tax policy or administration in any country need not only to understand the details of tax theory and practice but also the dark art of political salesmanship. This warning needs to be taken particularly seriously by those are concerned not only with how tax revenues may build up a more sustainable state but also with how the way in which such revenues are collected may contribute to, or detract from, the long-term development of state legitimacy.

Is ‘fiscal illusion’ a way to achieve sustainability? Consider earmarking, and what Breton (1996) calls the ‘Wicksellian connection’ between the two sides of the budget. Establishing such a linkage in the minds of people is critical to the whole issue of state legitimation.⁴⁴ Earmarking – linking specific revenue sources to specific expenditures -- has existed since the earliest recorded fiscal practices (Webber and Wildavsky 1986). Both politicians and taxpayers often find earmarking an attractive and feasible way to finance social security, road works, education, environmental programs, and other good things. Politicians like earmarking as a means of reducing taxpayer resistance to higher taxes. Taxpayers like the greater accountability they perceive with respect to how their tax dollars are spent. Economists, however, have come only lately to the table when it comes to understanding and analyzing this common fiscal practice.⁴⁵

Those concerned with budgeting almost unanimously conclude that earmarking is a bad thing -- often, it seems, implicitly assuming that budgetary decisions would otherwise be made by a benevolent dictator whose sole objective is to maximize social welfare. In more practical terms, budgetary experts, observing the mess that rampant

on the other hand they think that replacing the (largely withheld) income tax by a more visible RST may result in smaller government. Such arguments, on both sides, rest more on faith than on evidence.

⁴² Even thorough-going democrats might prefer some taxes to be hidden for the same reason people support forced saving schemes -- as a way of forcing themselves to behave more rationally in the long run (Elster 1984). Or they may prefer such taxes for paternalistic (or, perhaps, “merit good”) reasons similar to those of some supporters of social security systems -- to force others to behave more rationally (and thus ultimately in their own best interests) in the long run (Musgrave 1981).

⁴³ The major exception is Canada: see Bird (2009) for a recent examination of the Canadian case.

⁴⁴ This argument is, for example, one of the key elements in explaining the popularity (and mixed results) of fiscal decentralization around the world (Bahl and Bird 2008a).

⁴⁵ This discussion draws on Bird and Jun (2007).

earmarking has created in some countries, tend understandably to argue that no rational budgetary process is conceivable unless the practice is essentially banned.⁴⁶ This Gladstonian approach remained essentially unchallenged in theory until Buchanan (1963) revived an important efficiency argument (made earlier by Wicksell) in favor of establishing as tight a linkage as possible between taxing and spending decisions.⁴⁷ In this approach, earmarking is not simply a way to secure political consent for a tax increase. It may actually be the *best* way we have to deal with the fundamental normative problem of public economics -- how to provide people with the public services they really want -- where 'want' is interpreted in the only economically relevant sense of what they (collectively, as determined through their political institutions) are willing to pay for.

Like all fiscal institutions, earmarking comes in many variants. The economic case for earmarking is strongest when there is a close benefit link between taxes and spending and the revenues received are spent on the service in question. Benefit-related earmarking (like user charges) -- provided it is properly designed and implemented -- reveals taxpayer preferences for public services and sends a clear demand signal to the public sector about how much of a service should be supplied. Since revenues received (and only such revenues) are spent on the service in question, supply automatically adjusts to demand and economic efficiency is achieved. Such earmarking may also be considered equitable in the sense that no one receives a service without paying for it or pays without receiving service. Provided that the public service thus financed is like a privately supplied service in the sense that both an individual's consumption of the service and the marginal cost of providing the service can be satisfactorily measured, most people would probably consider such levies fair on the whole.⁴⁸ Since taxpayers are aware that when payments are extracted from them the funds will be used to pay for certain expenditures, they will presumably support the taxes or charges if, and only if, they support the expansion in the supply of government services for which the earmarked revenues are targeted. Both tax and expenditure decisions may thus be made more rationally than under general fund financing.⁴⁹

⁴⁶For example, the IMF, observing how badly public finances are run in many developing countries, commonly insists that an essential element of sound public financial management is a single Treasury account.

⁴⁷ Whether earmarking increases public trust in government or reduces it depends on the context. For example, earmarking (hypothecation) was widespread in Britain at the turn of the 19th century but was then rejected and replaced in mid-century by the 'Gladstonian' approach to public finance, an important feature of which was a consolidated budget with no earmarking (Daunton 2001). Interestingly, the stated reason for the turn away from earmarking was to *restrict* the growth of the state in order to restore public trust in the neutrality of the public finances in the face of the then-common perception that hypothecated revenues were being (mis)used by the political elite to expand the 'fiscal-military' state in their own interests. As this example suggests, as times change, what is "sound" policy may also change.

⁴⁸ Partial earmarking may be appropriate even if consumption of a particular public service generates external benefits for other households. In the limiting case in which the service is a pure public good and the marginal cost of extending service to another household is zero there is clearly no efficiency case for either user pricing or earmarking.

⁴⁹ In theory, properly designed earmarking may in certain circumstances be an effective way to enforce an inter-temporal agreement (Teja 1988). It may also provide an way to overcome the incomplete contracting problem that would otherwise exist, in effect by increasing the political costs to future governments of breaching the contract (Cremer, Estache, and Seabright 1995). In some instances earmarking may thus both

In practice, such perfection seems seldom to have been achieved. The relatively disappointing experiences with earmarking in many countries reflect many factors -- the cost and difficulty of controlling many separately budgeted funds (Fullerton 1996), the inappropriateness of many of the linkages that have been established for political reasons between particular revenues and expenditures (McCleary 1991), and the understandable resistance of citizens to attempts to charge properly for services that initially were provided 'free' or at highly subsidized prices (Bird and Tsiopoulos 1997). Much earmarking found around the world makes little economic sense. In many instances, not only is there no logical link between the tax imposed and the spending for which it is designated but there is also no solid budgetary link. The amount collected from the designated source and the amount spent on the designated activity are decided independently. What is the rationale for such non-logical non-linkages? Do they affect budgetary outcomes? These are not trivial questions. Many countries have many earmarked revenues, and new ones are likely created (or at least suggested every) day, not least in the environmental field.

One important rationale for imposing taxes earmarked to support some popular activity is simply revenue enhancement. Politicians justify the imposition of a new tax by capitalizing on the presumed 'halo effect' of something popular like education or health or 'greenness.' In some instances, earmarking may also be motivated by rent-seeking behavior. For example, an increase in tobacco taxes with the proceeds earmarked for increased health spending may receive support on all sides: from non-smokers, who would not pay the tax; but want more spending on health; from smokers who feel guilty about smoking and are worried about the health consequences of smoking; and also, of course, from the large number of people who are engaged in the health business and who (presumably) not only believe that higher taxes on tobacco and more spending on health are good but also realize that they would be clear gainers because health spending would increase as a result -- even though this need not necessarily happen. Some studies (Cnossen and Smart 2005) suggest that tobacco taxes are both highly regressive and already higher in many countries than can be rationalized on any externality arguments. Still, how can politicians resist such a win-win combination?⁵⁰

Even when people -- or the relevant elites -- feel overtaxed in general or are resistant to increases in taxation, new earmarking initiatives may sometimes be welcomed for reasons like those just mentioned. If the earmarking makes sense, then such initiatives may be economically sensible. However, except when there is a clear benefit rationale, it is hard for an economist to defend any form of non-benefit earmarking that actually alters expenditures (in the sense that the level of expenditure on any particular activity is determined at the margin by the amount of revenue collected from any particular tax or

provide voters with a way to pin down politicians about whom they are uncertain and politicians with a means of 'signalling' their concerns to voters in a credible way (Brett and Keen 2000).

⁵⁰ Earmarking tobacco taxes to health programs can be rationalized to some extent on 'benefit' grounds but is unlikely to have much effect on health spending. Earmarking such taxes to e.g. 'anti-tobacco' advertising campaigns may significantly increase the flow of funds to such activities (Jha and Chaloupka 2000) but this does not mean it is the best use of such funds.

charge). But is earmarking that is not economically sensible necessarily bad? Those who think that more taxes are needed for good purposes (whether people agree or not) so that revenues obtained by fiscal sleight-of-hand are better than nothing will not agree. Those who agree with Musgrave (2000, 101) “...that society is capable of resolving its common concerns in a reasonably efficient, just and democratic manner” must hope that, in the long run, as Abraham Lincoln once said, if one cannot fool all of the people all of the time it is unlikely that higher revenue levels than would otherwise be acceptable can long be sustained by manipulating fiscal illusions through symbolic earmarking.⁵¹

A corollary of this argument about earmarking is that sensible benefit-related taxes or fees should be levied when feasible with the proceeds earmarked appropriately. Unfortunately, this proposition too is seldom satisfied in reality. The fees, charges, and public prices found in most countries are seldom sensible. Indeed, an important question needing further study is why the impressive economic evidence supporting the case for marginal-cost pricing has had so little impact on policy? In many countries, budgets are littered with fees, charges, and minor taxes that could be abolished with little loss in revenue and some gain in efficiency. Even the few ‘benefit’ and ‘earmarked’ levies that in principle might have some potential economic rationale invariably need substantial revision to be conducive to efficient resource use.

There are many reasons for this sad state of affairs. For example, even in the best circumstances it is often surprisingly difficult to design and implement good user charges, and as a rule even good charges are not very popular with either administrators or citizens (Bird and Tsiopoulos 1997). Still, it is surprising that so little attention has been paid to these issues. Much can be done to improve revenue systems in most developing countries this respect. Those who look to “green” taxes as potential sources of future revenue should be particularly concerned to explore such questions. There is much to be gained in terms of efficiency (if not always revenue) by improving our knowledge of ‘extra-budgetary’ budgeting, earmarking, user charges, and the like. Such subjects are often considered peripheral to the core interests of public economics. This is a mistake: not only are such ‘fringe’ areas often central to improving tax and other policy outcomes in many countries but there is much to be learned by exploring them more carefully.

Play the Right Game

In the end, if tax research is to impact more effectively on tax policy, researchers must play the right game. Major changes in taxation generally require major changes either in the political reality of a country or in its economic circumstances. In normal times a ‘good’ tax reform—one intended to raise more revenue in a more efficient and equitable fashion—may be like a ‘good’ seat belt law: if everything else stays the same, lives will be saved (the tax ratio will increase). But things do not stay the same: some people drive

⁵¹ In some contexts, however, even symbolic earmarking may be understandable and justified as a way of signaling commitment and ensuring greater political accountability (Smart and Bird 2009).

faster when they are belted in (administrative efforts slack off, concessions to favored groups multiply) with the result that death rates (tax ratios) show little change. Countries appear to achieve a sort of equilibrium position with respect to the size and nature of their fiscal systems that reflects the balance of political forces and institutions and then to stay there, fluctuating around some relatively stable ratio, until ‘shocked’ into a new equilibrium (Bird 2003). Two alternative explanations may lie behind this process. Either -- somewhat improbably -- ‘supply’ (‘capacity’) factors may alter over time in such a way as to offset all attempts to raise tax ratios. Or, more plausibly, ideas as to the ‘proper’ tax level – ‘demand’ factors -- may change over time or may be articulated differently through political institutions.

As noted earlier, the tax policy world is very different in many respects now than it was 50 or even 20 years ago. Both the economic and the intellectual environment has changed. Ideas matter: as Blyth (2002, 274) puts it, “...neither material resources nor the self-interest of agents can dictate...ends or tell agents what future to construct. Ideas do this.” Of course, institutions and interests also matter in shaping tax policy. To understand the tax policy game, all these aspects need to be considered.

An example may help make the point. Some years ago an analysis of Central American tax policy argued that in principle changes in tax level structure (e.g., the degree of emphasis on income taxation) essentially reflected the changing political balance of power between landlords, capitalists, workers, and peasants (Best 1976). Shortly after this article appeared, an explicitly ‘leftist’ regime (the Sandinistas) took over in Nicaragua. What happened to taxes? Three things:

1. As Best (1976) would likely have predicted, the tax ratio rose very quickly, from 18 to 32% of GDP within the first five years of the Sandinista regime.
2. However, almost all the increase in tax revenue came from (probably) regressive indirect taxes and not from the (at least nominally) progressive income taxes.
3. In many ways most interestingly, once Nicaragua’s tax ratio was increased, it stayed up there even a decade (and three subsequent governments) after the defeat of the Sandinistas.⁵²

As this example suggests, political ideas definitely matter in taxation; but they do not necessarily dominate. Economic and administrative realities also matter. Few real-world tax structures have been designed with any particular objective in mind. Often, they have been shaped by both the changing local environment and the changing external context. In the case of the United States, for example, over the 1860 to 1920 period “economic crises and wars helped create a consensus for an income tax that falls most heavily on the wealthiest taxpayers (Weisman 2002, 366).” The lengthy debate about taxes that took place over this period was not really about taxes at all but rather about

⁵² Peacock and Wiseman (1961) had earlier explained a similar discrete jump in tax effort and public expenditure in post-war Britain as a ‘displacement effect’: general perceptions about what is a tolerable level of taxation tend to be stable until shocked by a social upheaval so that levels of taxation that would have been previously intolerable become acceptable and remain at the new higher level after the social perturbations have disappeared.

what kind of society Americans wanted. Much the same can be said about other countries.

Ideas on the relevant balance between taxes and society forged over the first half of the 20th century have changed in recent years, as evidenced for instance by both the death of death taxes in developed countries⁵³ and the limited success of developing countries in achieving the high levels of income taxation to which many of them aspired in the post-colonial period (Bird and Zolt 2005). As noted earlier, however, both tax levels and the distribution of tax burdens have changed less than have ideas about the nature of a good tax system. The question raised earlier of how best to make the ‘wicksellian connection’ operational is not simply as yet unanswered by tax research: it has not really been asked. It is clear, however, that the extent to which good decisions—that is, decisions that reflect people’s real preferences as closely as practically feasible—are made on either side of the budget cannot be separated from the question of the institutional structure within which political decisions are reached and expressed.

In the end, it seems, for tax research to help tax policy-makers make the *right* decisions is to ensure that they—as well as, ideally, all those affected—are as aware as possible of all the relevant consequences. If a country is to have a better tax system—better in the sense of giving people what they want (and are willing to pay for)—it must first have a better political system that transmutes citizen preferences into policy decisions as efficiently as possible. “Democracy,” as Churchill once said, “is the worst form of Government except all those other forms that have been tried from time to time.”⁵⁴ Bahl and Bird (2008a) suggest that ‘representation without taxation’ is not the way to produce good outcomes in decentralizing countries. Similarly ‘taxation without representation’ is not the way to create a fiscal system that is likely to be either economically or politically sustainable in the long run.

Taxation is always and everywhere a contested concept. Some pay and some do not. Some pay more than others. Some receive compensating services, some do not. Such matters are in democratic states resolved only through political channels. Indeed, history suggests that the need to secure an adequate degree of consensus from the taxed is one of the principal ways in which, over the centuries, democratic institutions have spread (Sokoloff and Zolt 2005). No non-dictatorial government in this age of information and mobility can long stay in power without securing a certain degree of consent from the populace, not least in the area of taxation. State legitimacy thus rests to a considerable extent on the ‘quasi-voluntary compliance’ of citizens with respect to taxation (Levi 1988). To secure such compliance in a sustainable way tax systems must, over time, represent in some real sense the basic values of at least a minimum supporting coalition of the population.⁵⁵

⁵³ For a neat explanation of this trend, encompassing changes in both economic structure and income inequality, see Bertocchi (2007).

⁵⁴ This quotation actually had a somewhat different implication in its original context, but nonetheless seems largely right even if one’s main concern is growth: as Lindert (2004, 344), concludes, history tells us that “the average democracy has been better for economic growth than the average autocracy....”

⁵⁵ Daunton (2001, 2002) shows that a great deal of attention was paid to precisely this task in Britain, with quite different tax levels and tax mixes being found most suitable to the ‘consensus-maintaining’ objective

The central problem in many Latin American countries, for instance, is clearly inequality (de Ferranti et al. 2004).⁵⁶ The key, and related, governance problem in most of the same countries is lack of accountability. A better tax system is critical to the solution of both problems. Reforms that link taxes and benefits more tightly such as decentralization and more reliance on user charges may help accountability -- though not necessarily reduce inequality.⁵⁷ On the other hand, reforms that replace highly regressive and inelastic excises by a less regressive and more elastic VAT may reduce inequality—especially of course if the increased revenues are invested in growth-facilitating activities such as education and infrastructure.⁵⁸ From a developmental perspective, the key function of taxes in developing countries is to provide (non-inflationary) funding for pro-poor and pro-growth spending programs particularly on developing human capital. The best way to achieve this goal in most countries is likely through a broad-based non-distortionary consumption tax like VAT, as has long been recognized (Heady 2004).

What countries actually do, however, is always and inevitably determined in the first instance by political and not economic calculations.⁵⁹ Countries vary enormously in the effectiveness and nature of their political systems. Some may be close to ‘failed states’ in which institutions are so ineffective that it does not matter much what they attempt to do: it will not work. Others may be ‘developmentalist’ and wish to use their fiscal systems as part of a relatively dirigiste interventionist policy. Still others may be of a more laissez-faire disposition. Some may be more populist, some more elitist, some more predatory.

The dominant policy *ideas* in any country (about equity and fairness, efficiency, and growth), like the dominant economic and social *interests* (capital, labor, regional, ethnic, rich, poor), and the key *institutions*, both political (democracy, decentralization, budgetary) and economic (protectionism, macroeconomic policy, market structure), interact in the formulation and implementation of tax (and budgetary) policy. Uniform results are unlikely to emerge from the always boiling policy cauldron, with its different mixes of ingredients in each country. The changing interplay of ideas, interests, and institutions affects both the level of taxation and its structure. Indeed, as Schumpeter

over the years. Gillespie (1991) tells a similar (more economics-focused) tale for Canada. Lieberman (2003) to some extent tells similar stories with respect to Brazil and South Africa. For a stimulating general model of the balancing of political and economic concerns in formulating and implementing tax policy in a democratic setting, see Hettich and Winer (1999). Tridimas and Winer (2004) in effect extend this framework to non-democratic settings.

⁵⁶ Some of the present discussion draws on a fuller exploration of the Latin American case in Bird (2003).

⁵⁷ As discussed earlier, another such reform is earmarking (Bird and Jun 2007), but this too may instead of improving matters worsen them if it captured by a particular interest as may happen all too easily even in developed and democratic countries. There is no such thing as a free lunch when it comes to institutional design.

⁵⁸ Note that one implication is that relevant analysis of the incidence of policy changes must often consider both sides of the budget: as Break (1974) noted, the ‘differential’ tax analysis beloved of economists (and followed in most incidence studies) is seldom the most relevant approach to incidence for policy purposes.

⁵⁹ Of course, as Hettich and Winer (1999) develop in detail, political and economic factors are often interdependent.

(1954) emphasized long ago, taxation is one of the clearest arenas in which to witness the working out of these complex forces.

Viewed in long-term perspective, few developing countries seem to have completed even the earlier parts of the long cycle that produced the (more or less) redistributive and (more or less) growth-facilitating fiscal states now found in most developed countries—the long preparatory period during which the idea of the desirability and even necessity of a larger state and a more or less progressive fiscal system became established to different degrees in different countries.⁶⁰ Some countries in Latin America, for example, might be argued to have moved more from the colonial inequality of land-based maldistribution to the modern inequality of capital-based maldistribution.⁶¹ The point here is not that all countries must follow the same evolutionary path. However, unless countries do so to at least some extent they are unlikely to develop tax systems resembling those now found in most OECD countries.

Many governments in developing countries -- not just those in Latin America -- are in dire straits. Even countries that have reached relatively safe harbors politically, achieving a certain degree of legitimacy and stability, almost always feel—often correctly—that they are in an economically precarious situation. The budget is politically and economically constrained. Life is difficult. Nothing can be done. All this may be true to some extent, but it is also both too much a counsel of despair and too easy a way out. Even in the most hopeless situations something usually can be done to improve matters. No doubt there will continue in most countries to be considerable dispute over what should be done to improve tax systems. Unless and until an adequate degree of political consensus on what should be done is achieved, no significant tax changes are likely to be made. In short, to a considerable extent the main tax challenge facing many developing countries is simply that there is as yet no implicit “... social contract between governments and the general population of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world” (Lledo, Schneider, and Moore 2004, 39).

History tells us that such principles do not become embedded either painlessly or quickly. The specific substantive suggestions that Lledo, Schneider, and Moore (2004) make to improve matters -- such as better VAT administration on a broader base -- are already the stuff of countless existing reports. I agree. Most countries should do all (or most of) the good things that experts tell them. The real question is: why have so many done so little? Lledo, Schneider, and Moore (2004, 40) suggest, perhaps rather wistfully,

⁶⁰ Compare the different, but parallel, stories told by Lindert (2003) and Alesina and Angeletos (2003) about how different developed countries have reached quite different fiscal equilibria. Why should uniform outcomes be expected in the much more heterogeneous developing world?

⁶¹ Warriner (1969) once noted, despairingly, that many Latin Americans did not seem to know what a good land reform means—probably because they had never seen one. Equally, in most countries of the region (as Engerman and Sokoloff (2002) almost—but not quite—say) most people may not know what either moderate or justifiable inequality might mean since they have never seen it.

that if Latin American countries wish to improve their tax systems they should “...improve political institutions in ways that broaden and deepen social contracts. For example, create more responsive and less clientelistic political parties, more cohesive and less polarised party systems, and improved capacity of civil society to monitor government and participate in tax debates.” In other words, what they say is that there can be no good taxation without good representation. They are right. But how useful is it to advise countries they should be something other than what they are?

Reforming taxes in any country is always a one-off operation in the sense that it occurs in the unique circumstances of that place at that time.⁶² Most studies of tax reform focus on the *substance* of what should be considered. A more fundamental question, however, is not *what* should be taken into account in developing a tax reform proposal but rather *how* the issues, whatever they are, should be approached (IDB 2006). McIntyre and Oldman (1975), for example, argue that more careful and comprehensive attention to institutional arrangements for tax reform will both improve the quality of the reforms proposed and increase the likelihood of their adoption and successful implementation. To be successful, for instance, reforms must be both comprehensible and fit with existing institutions. Even the best system for studying and developing reform proposals will never suffice to bring about good policy changes in the absence of a coherent strategy, continuing support from above, and an acceptable level of administration.⁶³ Good policy formulation is never enough; but presumably it is always better than its absence, or its opposite.

Some countries have tried to finesse the system by appointing some kind of special tax reform commission, whether foreign, domestic, or mixed. The track record of such efforts is not good. Appointing an outside group is often simply a way to postpone dealing with a problem. However good the final output of such efforts may be, the results are seldom ‘owned’ by those who must first sell them and then make them work. Ownership matters. So does leadership. So does a coherent strategy, and of course so do adequate resources. Good tax policy planning involves economists, lawyers, administrators, and – importantly – adequate discussion with taxpayers and “third party” tax collectors like banks and companies. Successful tax reform involves all this plus solid and continuing political support and adequate administrative follow-up. It is not easy anywhere. But it can be done.

Good planning and policy formulation focuses on what matters and what can be done and pays close attention to detail and implementation (Gillis 1989; Thirsk 1997). In particular, building up adequate institutional capacity in the tax field, both inside *and* outside government, is critical to being able to adapt policies to changing circumstances

⁶² Much of what follows relates only to ‘major’ tax reforms (Bird 2004a). Many countries constantly “reform” their tax systems by altering rates, redefining bases, and adding and clarifying interpretations to existing law. It is not always a simple matter to tell when such ‘technical changes’ constitute a major reform but this issue is not discussed further here.

⁶³ For example, as Yoingco (1976) shows, for many years the Philippines for many years had by far the best developed and institutionalized tax planning process in Asia and in some respects perhaps in the developing world. The results in terms of good policy, however, are not very evident.

and needs, thus ensuring some degree of robustness and resiliency (IDB 2006). The role of outsiders such as academics and aid agencies in this process is more to be supportive when countries want to reform their systems than to tell them when and how to do it. The most important long-term contribution outsiders have probably made to improving tax policy through research in many countries has been by encouraging, and even funding, informed non-government 'think tanks' and university studies in relevant fields (including foreign training) as well as by fostering data gathering and analysis both within and outside government. Such activities are not glamorous and seldom produce clear short-run pay-offs. Nonetheless, they are critical to establishing institutions that, over time, will be able to provide ideas and information that may inform (and perhaps even make more articulate) the interests that shape tax systems.

In the end, if a country needs or wants better tax policy or administration, it can have it: the answer largely lies in its own hands. Even those who want to do the right thing, however, can often use help in finding out just what is right and how it can best be done. It is always easy and seldom effective for those not in a game to give advice to those who are trying to play it. In general, however, academic researchers and outside agencies interested in fostering better sustainable tax systems in developing countries will employ their efforts and resources most usefully if they play in the right game. Fifty years of experience tells us that the right game for tax researchers is not the short-term political game in which policy decisions are made. Instead, it is the long-term game of building up the institutional capacity both within and outside governments to articulate relevant ideas for change, to collect and analyze relevant data, and of course to assess and criticize the effects of such changes as are made. Tax researchers can and should play an active role in all these activities. Such long-term 'institution-building' activities are seldom immediately rewarding. They appear to be out of fashion with international agencies concerned with development. It seems much more appealing and immediately productive to establish performance benchmarks for success, to support this particular organizational change reform here (revenue authority) and that new technology (computerization) there, in the apparent belief that such simple 'one-size-fits-all' approaches can provide quick (but sustainable!) answers to the many complex problems inherent in policy reform in difficult environments. It may be appealing. But it is wrong.

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